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IN THE
Supreme Court of the United States
OCTOBER TERM, 1997

BANK OF AMERICA NATIONAL TRUST
AND SAVINGS ASSOCIATION,
SUCCESSOR BY MERGER TO BANK OF AMERICA ILLINOIS,
Petitioner,

v.

203 NORTH LASALLE STREET PARTNERSHIP,
Respondent.

**On Writ of Certiorari to the
United States Court of Appeals
for the Seventh Circuit**

BRIEF AMICUS CURIAE OF THE NATIONAL ASSOCIATION OF CREDIT MANAGEMENT IN SUPPORT OF RESPONDENT

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BRIEF AMICUS CURIAE OF THE NATIONAL ASSOCIATION OF CREDIT MANAGEMENT IN SUPPORT OF RESPONDENT

The National Association of Credit Management ("NACM") respectfully submits this brief *amicus curiae* in support of Respondent.[1] Petitioner (the "Bank") and respondent ("Reorganized LaSalle") have consented to the filing of this brief, and their letters of consent have been filed with the Clerk of the Court.

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[1] In accordance with Supreme Court Rule 37.6, NACM represents that no party other than counsel for NACM authored this brief, in whole or in part, and no person or entity, other than NACM, has made a monetary contribution to the preparation or submission of this brief.

INTEREST OF *AMICUS CURIAE*

NACM is a non-profit professional trade association comprising approximately 30,000 members who are unsecured credit grantors involved in all aspects of the granting and extension of commercial credit. For more than 100 years, NACM has been the single trade association representing the interests of unsecured credit grantors in commercial transactions. NACM's membership represents the entire spectrum of those who extend commercial credit, from representatives of the largest publicly held national corporations to small local manufacturers, wholesalers, distributors and retailers.

Members of NACM participate in virtually every case commenced under Chapter 11 of the Bankruptcy Code that involves a business entity. In significant Chapter 11 reorganizations under the Bankruptcy Code since its enactment in 1978, NACM members have chaired and participated in nearly all creditors' committees, which are chosen to represent the unsecured creditor body. The interests of NACM members often diverge from the interests of secured creditors, especially in cases involving the question at issue in this appeal. Unlike secured creditors that have a mortgage or other security interest in property of the debtor, NACM's members provide unsecured credit to the debtor pre-bankruptcy and then provide unsecured trade credit to continue the operation of the debtor business. Thus, NACM members are essential to a company's ongoing viability as debtor in possession and later as a reorganized entity post-confirmation.

Unlike some of the amici on behalf of the Bank, NACM's members are involved in almost every type of Chapter 11 reorganization proceeding, not just those involving real property. Because the outcome of this case will affect the entire spectrum of bankruptcy reorganization proceedings, from the smallest case to the largest case and in every business sector, the Court's review of

the instant case will profoundly affect all unsecured commercial credit grantors.

SUMMARY OF ARGUMENT

1. This Court need not venture beyond the language of the Bankruptcy Code to resolve the issue before it. When, as in this case, two classes of unsecured creditors are not paid in full and one class votes in favor of the proposed plan while the other class votes against the plan, the Code requires confirmation of the plan supported by the class voting in favor of it if additional conditions are met. 11 U.S.C. § 1129(b)(1). When one class votes against the plan, equity owners of the pre-bankruptcy debtor are barred from *receiving property under a confirmed reorganization plan* only if such property is given *on account of* their equity ownership in the pre-petition business. No section of the Code prohibits any group—past creditors, past equity owners or complete strangers—from purchasing either assets or equity ownership in the newly reorganized debtor through a Chapter 11 plan.

2. Both the principle and practice that some owners of the pre-bankruptcy business purchase stakes in the newly-reorganized business was well established under the Bankruptcy Act of 1898. The Supreme Court made clear that no one was barred from purchasing equity in a reorganizing business, if they paid fair consideration for their purchase. *Northern Pac. Ry. Co. v. Boyd*, 271 U.S. 445 (1926). If Congress had intended to overrule this long-established view, it could easily have done so by explicitly prohibiting the participation of previous investors in any subsequent plan of reorganization. Congress did not.

3. The plain language of the Code reflects a coherent view of bankruptcy policy. Chapter 11 favors debtor rehabilitation over liquidation, so long as the creditors are adequately protected. When creditor groups differ over whether a plan should be confirmed, the Code requires

confirmation with the added restrictions that the plan not "unfairly discriminate" among the classes that accepted and rejected the plan and that the plan be "fair and equitable." 11 U.S.C. § 1129(b)(1). In recognition of the frequent need for cash infusions in business reorganizations, Congress did not bar anyone from purchasing property or equitable ownership of the business. Those who make no contribution are barred from taking value unless higher priority classes either are paid in full or consent to such an arrangement. But a single class of creditors does not have the power to defeat a plan that other creditors support and that meets the numerous requirements for plan confirmation solely because the dissenting class objects to the source of the funds contributed by one or more investors in the soon-to-be-reorganized company.

If dissenting creditors wish to object to the tems of a purchase and sale under a reorganization plan, the Code provides a number of mechanisms for doing so. 11 U.S.C. §§ 1123, 1129 (specifying more than 30 elements of a plan eligible for confirmation). If a creditor wishes to object to a debtor's exclusive right to propose a plan and to propose its own plan, it may do so. Additionally, it may object to the confirmation of any plan proposed by any party. 11 U.S.C. §§ 1121(b), 1128(b). But automatic disqualification of any plan based on who invests in the reorganized company presents a novel argument that is contrary to long-established bankruptcy policy.

ARGUMENT

I. CONGRESS CAREFULLY BALANCED THE INTERESTS OF COMPETING CREDITORS, WITH A STATED AIM FAVORING REORGANIZATION OF TROUBLED BUSINESSES.

Plan confirmation is not a two-party negotiation between a debtor and a creditor. Characterizing the issue as a competition between the rights of the debtor and the

rights of the creditor misapprehends the central function of business reorganization: Chapter 11 is a court-imposed settlement of multiple relationships affecting a number of parties. Some parties are direct stakeholders in the case, including secured creditors, unsecured creditors, and equity holders. Managers of the debtor and trustees are identified parties in interest. In addition, employees who may lose jobs, communities that may lose important businesses, taxing authorities that may lose sources of revenue and other businesses that may lose critical customers or suppliers were very much in the mind of Congress as it determined how many hurdles would be erected to the reorganization of a potentially viable business. *See, e.g.*, 124 Cong. Rec. 32,392 (Sept. 28, 1978) (statement of Rep. Edwards) (discussing policies in the new Code to "protect the investing public, protect jobs, and help save troubled businesses"); H.R. Rep. No. 95-595, 53-62 (Sept. 8, 1977), *reprinted in* 1978 U.S.C.C.A.N. 6014, 6023 (discussing concern about the community impact of business failure); 124 Cong. Rec. 33,990 (Oct. 5, 1978) (statement of Sen. DeConcini) (discussing "the public interest" beyond the interests of the disputing parties). The question before this Court is whether Congress decided that a single class of creditors could prevent the confirmation of a feasible plan of reorganization because any part of the funds for reorganization came from a party who had an equitable ownership interest in the prefiling business.

The Solicitor General suggests that if a plan is a good plan, then the creditors will vote for it. *Solicitor's Brief* at 27. This is undoubtedly true, and it may be the reason that Congress required that at least one class of impaired creditors vote in favor of a plan of reorganization before it can be adopted over the objection of a dissenting class. But the problem is not, as the Solicitor General's brief seems to suggest, what to do when no creditors favor a

plan the debtor proposes; those plans cannot be confirmed as a matter of law. 11 U.S.C. §§ 1129(a)(10), (b)(1). The problem occurs when one class of creditors supports the plan while another class rejects it.

The problem of choosing between classes of creditors that support the plan and classes that oppose the plan is particularly acute because some creditors vote strategically in Chapter 11 cases. Some creditors appear in only one class, while other creditors appear in two classes. This happens because of the claims calculation procedure in the Code. When a secured creditor is owed more money than the value of the collateral securing the loan, the claim is bifurcated into its secured and unsecured portions, each portion of which is treated separately under the plan. 11 U.S.C. § 506.

Secured creditors frequently favor liquidation so that they can seize control of specific assets, knowing they can rely on these assets for payment rather than on a stream of payments from the ongoing business. For some secured creditors, the seizure of assets results not just in repayment of the debt, but in substantial profits: UCC 9-504 permits a creditor to seize collateral subject to a security interest and, after proper notification to the debtor, re-sell the assets and keep all the proceeds, even if they exceed the value of the loan.[2] In addition, through foreclosure of the assets, secured creditors can sometimes effectively seize an entire business and maintain operations, free of the claims of unsecured creditors and the old owners. In recognition of this fact, Congress decided that secured creditors may not exercise their contractual

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2 Barkley Clark, *The Law of Secured Transactions Under the Uniform Commercial Code* ¶ 4.09[2] (rev. ed. 1993); James J. White & Robert S. Summers, *Uniform Commercial Code* § 25-9 (3d ed. 1988); 2 Grant Gilmore, *Security Interests in Personal Property* § 44.6 (1965).

rights to seize collateral when the debtor is in default, so long as the debtor can provide adequate protection of the value of the collateral. 11 U.S.C. § 362(d). In the same vein, Congress decided that secured creditors may not block a reorganization, so long as they are paid the present value of the collateral under the plan. 11 U.S.C. § 1129(b)(2)(A).

Because their bankruptcy claims are bifurcated into secured and unsecured portions, undersecured creditors get the chance to vote the unsecured portion of their claims. Such creditors may willingly give up any chance at a distribution as unsecured creditors in order to liquidate assets or take control of the business in their role as secured creditors. By contrast, some creditors, such as trade creditors, employees, and tort victims of the debtor, have no secured claims and no collateral to call on. They will be paid only if the debtor is reorganized. When two classes of unsecured creditors vote in a Chapter 11, one votes its best interests as a secured creditor while the other votes its best interests as a creditor who can recover only through reorganization.

The interests of secured and unsecured creditors diverge in yet another way. Once the debtor is in financial trouble, the secured creditor has no interest in a continuing business relationship with the debtor and frequently terminates the business relationship. The secured creditor hopes to be paid in full and exit without a loss. For many of the unsecured creditors, however, the relationship continues. Unsecured creditors, particularly tradespeople and employees, typically will continue to do business with the company while it is in bankruptcy and hope for a future with the company as a customer, supplier, or employer after the reorganization. In effect, many trade creditors continue to invest in the debtor by either selling goods on credit or buying goods on credit after the bankruptcy filing. Even employees invest in the

debtor with labor, wage give ups and loans from employee pension plans. The view of secured and unsecured creditors often diverge sharply as they consider the possibility that a troubled business may reorganize in bankruptcy.

Congress provided for bifurcation of claims in order to limit the leverage of secured creditors, which had often exceeded their interest in recovering the value of their collateral. The legislative history explicitly addressed the policy decision, opting to limit the power of the secured creditors in order to promote the reorganization of failing businesses.[3] Bifurcation of claims posed no obvious threat to the debtor's ability to reorganize because the plan proponent was given the opportunity to confirm a plan that had the backing of at least one im-

[3] Congress provided for bifurcated claims to try to limit the power exercised by secured creditors, particularly those creditors with undersecured loans. The Report of the Committee of the Whole House on the State of the Union states:

> Unlike current law, H.R. 8200 distinguishes between secured and unsecured claims, rather than between secured and unsecured creditors . . . . Current law is ambiguous and vague, especially under Chapter XIII, on whether an undersecured creditor is to be treated as a secured creditor, or as a partially secured and partially unsecured creditor. By addressing the problem in terms of claims, the bill makes clear that an undersecured creditor is to be treated as having a secured claim to the extent of the value of the collateral, and an unsecured claim for the balance of his claim against the debtor. . . . Because of the uncertain treatment of secured creditors under current law, the debtor is often required to err on the side of overprotection when formulating a reorganization or repayment plan. Secured creditors have exercised great leverage by virtue of the uncertainty, and have made reorganization and individual repayment plans more difficult to consummate than would be the case under this bill. Since a successful reorganization or Chapter XIII plan inures to the benefit of all creditors, the change under the bill should increase recoveries by creditors generally.

H.R. Rep. No. 95-595. As this language illustrates, it was not the intent of Congress to create a veto power for undersecured creditors.

paired class of unsecured creditors—even if the plan was opposed by another class of creditors. 11 U.S.C. § 1129(b). This mechanism sharply curtails the power of a dissenting class of unsecured (or undersecured) creditors to derail an otherwise-confirmable plan.

The overall scheme of the Code is consistent: Dissenting creditors within a class are overridden if the class votes to accept the plan, making it possible to confirm a plan "by consent" even when some creditors object. 11 U.S.C. § 1126(c). Similarly, dissenting classes are overridden if another class accepts the plan and the other requirements of section 1129 are met. 11 U.S.C. § 1129(b).

In favoring reorganization, the Code expresses the deliberate policy choices made by Congress. "It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets." H.R. Rep. No. 95-595, *reprinted in* 1978 U.S.C.C.A.N. 6014, 6179. This Court has also consistently recognized that principle: "The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources." *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984). "By permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners. . . . Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap' " *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983).

The Code balances the interests of accepting and dissenting creditors by imposing specific requirements before a plan may be adopted over the objection of a dissenting creditor: the plan may not unfairly discriminate among classes, the plan must be fair and equitable, and the plan may not distribute any value to pre-petition equity holders

on account of their ownership claims over the objections of a dissenting creditor class. 11 U.S.C. §§ 1129(b)(1), (2)(B)(ii). If the plan proponent can satisfy these three requirements, in addition to all other requirements in 1123 and 1129(a), then the plan must be confirmed. Congress understood the divergence among different stakeholders, emphasizing that protection for those other stakeholders "should not be left to a plan negotiated by a debtor in distress and senior or institutional creditors who will have their own best interest to look after." S. Rep. 95-989, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5796. The Code tilts toward confirmation of a plan that is both supported by one or more creditor groups and is otherwise equitable in its treatment of the dissenting creditors; the Code denies a single undersecured creditor the power to deplete the remaining value of a failing business.

The Code neither restricts the source of funds for the reorganization of the debtor nor gives any party the right to stop a reorganization because it objects to the source of the funds to be used in the reorganization. To do so would enhance the power of dissenting classes, giving secured creditors with bifurcated claims a much greater opportunity to force liquidation of viable companies or to seize control of such companies, thereby wiping out the interests of the unsecured creditors and equity. Such a rule would re-create the "hold-out" problem that the 1978 Code was designed to correct.[4] Under the Act, a

[4] Efforts to deal with the holdout problem in reorganizing a failing business long pre-date the adoption of the 1978 Bankruptcy Code. Professor Markell explains:

> Starting in 1874, federal legislation attempted to foster compositions by providing that, if certain procedural requirements were met, a less than unanimous composition could be confirmed by a bankruptcy court. Its terms would then become binding on all creditors, even those who did not agree with the composition. The 1874 legislation, which had its roots in English and Scottish law, bound dissenting creditors if two requirements were met: first, approval by a majority of creditors, holding three-quarters of the debt owed, who were present at a duly convened meeting of creditors, and second, written confirmation of the earlier approval by at least two-thirds of all the debtor's creditors who themselves held at least a majority of the debt owed by the debtor.

Bruce Markell, *Claims and Opinions: Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification*, 11 Bankr. Dev. J. 1 (1994/95) (footnotes omitted).

Finance specialists note that Chapter 11 reorganizations enjoy an advantage over workouts outside bankruptcy because they can solve the holdout problem. *See, e.g.*, Varouj A. Aivazian & Jeffrey L. Callen, *Corporate Leverage and Growth*, 8 J. Fin. Econ. 379, 397 (1980).

creditor who refused to go along with a plan supported by other creditors could hold out, threatening to vote no unless the other creditors or new equity investors paid something more to the holdout. To curb the holdout problem, the 1978 Code provided both that creditors vote by class and that no single class block a plan, thereby sharply curtailing the veto power of a single creditor or small group of creditors. Because their power to block a plan has been reduced, the holdout creditor's negotiating leverage during the course of a Chapter 11 case is also checked.[5]

The briefs make clear that the secured creditors want more power in a business reorganization than the Code currently gives them. The unsecured creditors, for whom

[5] In the instant case, the secured creditor negotiated for a nonrecourse loan, voluntarily restricting its recovery to the collateral itself. It has a voting position in this case only by operation of section 1111(b), which was added to the Code in 1978 to protect nonrecourse secured creditors from having "consensual" plans imposed on them. Section 1111(b) allows undersecured creditors to vote the unsecured portions of their claims. The Seventh Circuit requires those claims to be separately classified. *In re Woodbrook Assoc.*, 19 F.3d 312, 319 (7th Cir. 1994). The secured creditors in this case propose to take that opportunity to vote and turn it into a sword to block any plan they do not support. There is no suggestion in any part of the legislative history that Congress intended them to enjoy such power by virtue of their new-found voting rights.

the reorganization effort is largely directed, oppose this effort to shift the balance carefully constructed by Congress.

II. THE CONGRESSIONAL SCHEME IS PREDICATED ON AMPLE ACCESS TO CAPITAL TO PROMOTE SUCCESSFUL REORGANIZATIONS.

Most businesses undergoing financial reorganization need access to new capital. Some will use the money to modernize their facilities. Others will use the new capital to make their payroll and pay the costs of operation until the business generates sufficient revenue to pay its own bills. It is a rare business in Chapter 11 that does not need a new source of funds as part of its reorganization plan.

For very large companies, access to the capital markets may be largely unrestricted. Because of the bankruptcy, the costs of funds may be high, but they are likely to be available. For smaller businesses, however, capital is more difficult to find,[6] a problem that is magnified for the small business in bankruptcy.[7] The market for debt for dis-

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[6] Robert F. Reilly, *Value and Cents: Valuation—Big Businesses vs. Small Businesses*, 1995 Am. Bankr. Ins. J. 126 (September 1995), observes: "Generally, big businesses have debt financing available, regardless of the credit worthiness of the owners, whereas it is not generally available for the smaller business. Alternative sources of financing, such as the owner's capital, are needed. In addition, personal guarantees are typically required for debt financing for small businesses." *See also* Alan Schwartz, *A Theory of Loan Priorities*, J. Legal Stud. 209 (1986); Robert Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901 (1986); Marsh, *The Choice Between Equity and Debt: An Empirical Study*, 37 J. Fin. 121 (1982).

[7] As one analyst observed, the argument that modern capital markets provide adequate access to funds needed for reorganization might apply to large entities filing Chapter 11, but "it ignores the difficulty that small businesses may encounter when trying to raise substantial new capital. Small business owners may not have the

tressed small businesses is so limited that old owners of the business may be the only source for new capital.[8]

There are a number of reasons that old equity may be more inclined to finance a small business than a stranger would be.[9] Information costs for small companies are high, and old equity may know more about the distressed company than new investors. In some cases, old equity actually runs the business. Preservation of the business may mean preservation of jobs for the owner or family members. In other cases, such as the instant case, old equity will derive some tax advantages if the business is not liquidated. In still other cases, equity will have made personal guarantees to one or two creditors, and they hope that by making an additional investment in the business that it will survive to pay the guaranteed loans. Sometimes old equity will make a new investment in the business because they can make unique contributions, such as business contacts, that would be lost if the business were owned by strangers. Whatever the specific reason, most owners of small businesses continue in their ownership position after a Chapter 11 reorganization, often with the consent of their creditors. Lynn LoPucki, *The Debtor in Full Control—Systems Failure under Chapter 11 of the Bankruptcy Code?*, 57 Am. Bankr. L.J. 247, 267-68 (1983).

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collateral and resources available to larger corporations making it more difficult for them to borrow money in today's capital markets." (footnotes omitted). Michelle Craig, *Note & Comment: The New Value Exception: A Plea For Modification or Elimination*, 11 Bankr. Dev. J. 781 (1995), in a discussion of the briefs filed in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988). *See also* Charles W. Adams, *New Capital For Bankrupt Reorganizations: It's The Amount That Counts*, 89 Nw. U.L. Rev. 411, 426 (1995) (stating that "an insolvent corporation's former owners are often the only feasible source of new capital").

[8] Elizabeth Warren, *A Theory of Absolute Priority*, 1991 Ann. Surv. Am. L., 1991 N.Y.U. School of Law 9, 15-16, 19-22.

[9] *Id.* at 19-22.

Small businesses with restricted access to capital make up the bulk of the companies that use Chapter 11. In the eleven year period from 1980 to 1991, for example, publicly traded companies represented less than one-tenth of 1% of all Chapter 11 cases (0.000936 of the cases).[10] For many of the 99.9% private companies in bankruptcy, access to capital infusions from former owners of the business may be the only hope for survival of the business.

When Congress drafted Chapter 11, it planned to cover all types of business with a single scheme, replacing the three-part business reorganization system of the 1898 Act. Under the Act, after 1952, neither Chapter XI (for small businesses) nor Chapter XII (for real estate entities) had an absolute priority rule. Absolute priority was recognized only in Chapter X, for publicly traded companies, and then only with its new value corrollary. It would have been a quite remarkable step for Congress to deny access to capital in the largest bulk of cases to be covered by the new Chapter 11 with no debate, no legislative history and no direct language to make clear that a sea-change in reorganization law was taking place.[11]

The practical advantages of permitting old equity the opportunity to participate in a reorganized business in return for a cash contribution has infused the development of reorganization law. Early courts recognized that everyone may benefit when the creditors make deals with the equity owners to get a business back on its feet. Neither the bankruptcy law nor common law required that equity be barred from any participation in the post-bankruptcy business. In 1926, this Court stated:

> Generally additional funds will be essential to the success of the undertaking, and it may be impossible

[10] Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 Yale L.J. 437, 441 (1992).

[11] *See* Bruce Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy*, 44 Stan. L. Rev. 69, 101-02 (1991).

> to obtain them unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them. In such or similar cases, the chancellor may exercise an informed discretion concerning the practical adjustment of the several rights.[12]

If Congress had not wanted old equity to continue to participate in plans of reorganization, it could have easily said so. It could have barred equity participation, either directly or by permitting a single class of creditors to block any plan to which it objected—thus permitting equity participation and confirmation of a plan only with the consent of every class. The amicus brief of the law professors specifically proposes that this be made the law:

> The code puts the reorganization decision in the hands of the creditors who are the residual owners of the insolvent firm. Here those creditors have decided to reject the plan proposed by the prepetition equity holders. . . . If the equity holders cannot convince the creditors that such a concession is in the creditors' own interest, it makes little sense to allow a bankruptcy court to substitute its opinion for that of the creditors.

Law Professors' Brief at 4. Both the Bank and the Solicitor General endorse this approach, asserting that "creditor consent" is a prerequisite for confirmation. *Petitioner's Brief* at 30; *Solicitors' Brief* at 27. This approach reads section 1129(b) out of the Code, substituting instead a scheme that permits a single creditor class to veto a plan. But Congress specifically permitted plans to be confirmed with the support of one class of creditors and the objection of another.

The Code does not bar participation of old equity in business reorganizations. Despite the fact that small businesses have gone back to their equity owners for additional infusions of cash throughout this century, Congress

[12] *Kansas City Terminal Ry. Co. v. Central Union Trust Co.*, 271 U.S. 445 (1926).

elected to restrict the participation of equity in plans only by saying that equity could not "receive or retain under the plan on account of such junior claim or interest any property." 11 U.S.C. § 1129(b)(2)(B)(ii). The Code unambiguously permits old equity to participate if it receives something other than "property" *or* if it receives property in some way other than "under the plan" or if it receives value "on account of" something other than its pre-bankruptcy claim.

III. THE CONGRESSIONAL SCHEME DOES NOT REQUIRE THAT REORGANIZATION PLANS BE AUCTIONS.

New value plans propose an exchange: equity ownership in the post-reorganization entity in return for a contribution of fresh capital. Because the new value is given in exchange for the new equity ownership, there is no violation of the absolute priority rule articulated in section 1129(b)(2)(B)(ii) which requires that old equity "not receive or retain under the plan on account of such junior interest any property." The Bank does not deny that a cash contribution in return for an equitable ownership does not violate section 1129(b)(2)(B)(ii). Instead, the Bank and amici ask this Court to impose an auction of the equitable interest any time a cramdown plan involves an equity contribution.

The fact that the plan proposed a specific sale price to a specified party that had had a previous ownership interest in the debtor is the Bank's basis for claiming a violation of 1129(b)(2)(B)(ii). The Bank explains repeatedly and with emphasis: "[T]he plan of reorganization gave the debtor's pre-bankruptcy equity holders the *exclusive* right to retain their ownership interests in the debtor if they contributed new capital." [emphasis in original] *Petitioner's Brief* at 6. This *exclusive* right under the plan is the same as in any purchase agreement: a statement of the sale price for equitable ownership, identification of the buyer and specification of the finance

terms. The Bank claims that *any* plan that proposes to sell equity in the reorganized business directly to a former equity owner is automatically ineligible for confirmation if one class of credtiors objects.

The Bank makes an interesting concession early in its brief: "We concede that the argument that pre-petition equity holders enjoy their post-petition interest 'on account of' their prior interests loses much of its force when an open auction is held . . . ." *Petitioner's Brief* at 11, n.6. The Bank is quick to point out that it is not complaining about the fact that the plan was proposed during a time when the debtor had an exclusive right to propose a plan. *Petitioner's Brief* at 6, n.4. Recognizing that sections 1121(b) and (d) grant an exclusive period to the debtor to propose a plan and that plans can—and should—be confirmed during this period, the Bank acknowledges that cramdown plans do not involve a transfer "under the plan" of any "property" interest simply because they are proposed during the period of exclusivity.

> [The Bank's argument] is not to be confused, and the Seventh Circuit did not confuse it, with the defeasible exclusivity of the debtor's right to *propose a plan*. *See* 11 U.S.C. § 1121(b). All that anyone other than old equity holders can gain if the latter exclusivity is terminated is the right to *ask the judge* to confirm a plan other than that proposed by the debtor, which may allow someone other than old equity holders to bid on the new equity. The judge is still permitted to confirm only one plan, and that plan must still satisfy the requirements of the statute. 11 U.S.C. § 1129(c) [emphasis in original]

Petitioner's Brief at 6, n.4.

Since the Code clearly contemplates the exchange of property for money and the proposal of cramdown plans during the period of exclusivity, in order to prevail, the Bank asks this Court to impose a new rule in cramdown cases: a requirement that each cramdown plan itself must provide for an auction of the equity interest. The Bank

cites no statutory language imposing such a requirement. Nor does the Bank cite any legislative history that suggests Congress had in mind auctions in all cases involving old equity. Nor does the Bank cite to a single pre-Code case in which an auction was required to permit equity participation in a plan of reorganization.

There is no evidence that, under the Act, courts required the use of auctions to transfer equity interests in new value cases. In the only new value case to reach this Court after the adoption of the Code, the old owners proposed to exchange their future labor for equity ownership of the post-reorganization business, which this Court ruled was not a cash equivalent. *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988). No one—including this Court—suggested in that case that the failure to propose an auction was fatal to the adoption of the plan or mentioned auctions in any connection.

The Bank reveals the novelty of its position by admitting in a footnote that, while it is sure that the Code requires that auctions be held if new value plans are to be adopted, it is not entirely certain that the bankruptcy court can hold such auctions or that the statute provides any foundation for the terms on which they might be conducted:

> The separate question whether the bankruptcy court has the authority to hold such an auction, however—particularly on its own motion and not in the context of a plan that sets forth in detail the procedures that will purportedly govern any such "auction"—raises issues involving construction of a number of different provisions of the Code. Because no auction was held or proposed in this case, however, the question is not before the Court.

Petitioner's Brief at 11, n.6. The Bank neither specifies any of the "number of different provisions of the Code" that would be invoked to confirm every new value plan nor identifies any statutory sections that contemplate that auctions are a necessary ingredient in new value plans.

The Bank's logic is tangled. Because the Bank cuts its argument loose from the exclusive right to propose a plan, the Bank's proposal would apply even if a dozen parties proposed plans of reorganization, each of which identified a different purchaser of the post-reorganization business. By the rule proposed by the Bank, all the plans could be confirmed, even over the objection of one class of creditors, except the one that proposed an equity buyer—even if the equity buyer were the highest bidder. The Bank takes pains to avoid hinging its argument on the losing proposition that exclusivity granted under section 1121(b) becomes "property" transferred "under the plan" "on account of" the equity interest. In doing so, it creates the conundrum that a highest-value plan chosen from among competing plans would not be eligible for confirmation because it conveyed "property" to equity by proposing a specific sale price to an old equity owner rather than proposing an auction to any bidder.

As the Bank's and amici's briefs reveal, there is no colorable violation of absolute priority without an exclusivity claim. But the rules governing the exclusive right to propose a plan lie elsewhere in the Code. 11 U.S.C. § 1121(b). In fact, the Bank filed a motion in the bankruptcy court seeking to terminate the Debtor's exclusive right to file a plan and sought leave to file its own liquidation plan, which the bankruptcy court denied. The Bank neither appealed that denial nor raised that denial as an issue on appeal when the Debtor's Plan was confirmed. Presumably the motion to terminate exclusivity was properly denied by the bankruptcy court under the terms of the statute. Congress has addressed the question of debtor exclusivity in section 1121(b). The Bank asks this Court to make an end-run around that provision to make the grant of exclusivity useless in any case in which the debtor offers to finance any portion of the post-reorganization business.

Secured creditors in Chapter 11 cases are not unhappy with equity's purchase of an interest in the reorganized

entity; they are unhappy that any plan can be confirmed over their objections. They ignore the value exchanged by equity for ownership in the reorganized business, focusing their argument instead on exclusivity granted to the debtor under the Code. Once again, the congressional decision to permit a debtor an extended period of exclusivity is part of the deliberate scheme to balance the competing interests of creditors and to promote the likelihood of a successful reorganization. Congress recognized that if creditors could propose competing plans of reorganization, the plan confirmation process would be more chaotic and the likelihood that any plan would be confirmed would decline sharply.[13] Congress also recognized that having the exclusive right to propose a plan put leverage in the hands of the Debtor—leverage to confirm a plan on terms different from those proposed by the most powerful creditor, leverage to confirm plans that would pay unsecured creditors some return on their debt rather than forcing them to stand by with nothing while the secured creditors took all the assets of the business, and leverage to maintain the business and its accompanying jobs and other benefits for the local communities. By putting this power in the hands of the Debtor, the Debtor was given the opportunity to confirm plans of reorganization for businesses that otherwise would have been liquidated.

The exclusive right to propose a plan is not unrestricted. The court may "reduce or increase" the period of exclusivity "for cause." 11 U.S.C. § 1121(d). Any creditor is free to bring such a motion at any time. *Id.* There is a rich and detailed case law and academic literature about the circumstances under which plan exclusivity should be

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13 "Proposed Chapter 11 recognizes the need for the debtor to remain in control to some degree, or else debtors will avoid the reorganization provisions in the bill until it would be too late for them to be an effective remedy." H.R. Rep. No. 95-595, *reprinted in* 1978 U.S.C.C.A.N. at 6191.

terminated.[14] Secured creditors may believe that courts have given Debtors too much leverage by extending plan exclusivity, while Debtors and unsecured creditors may think that courts are unrealistically restrictive in their willingness to grant exclusivity. Whether either party is right is not relevant to this case. The tension between the two demonstrates the bargaining dynamic deliberately created by Congress to push cases toward reorganization.

The secured creditor in this case hopes to make an end-run after losing its fight to have exclusivity terminated: it hopes to persuade a court to rule as a matter of law that it can veto any plan proposed during the period of exclusivity. If it could do so, it would increase the leverage of undersecured creditors far beyond what Congress contemplated, thereby upsetting the balance carefully achieved between all the competing parties who are dealing with a failing company.

Undersecured creditors may have a legitimate complaint; perhaps they should have greater power to liquidate or take over troubled companies. Of course, unsecured creditors would see that differently; they believe that undersecured creditors already exercise too much power in Chapter 11 cases, leaving trade debt, tort debt, employee retirement funds and other such creditors with too little recovery. In either case, however, the question of drawing the boundaries between debtors and creditors is one left to Congress.

Secured creditors have pressed their agenda, asking for limits on exclusivity, an absolute right to veto plans and increased powers to determine classification among different creditor groups. Thus far, Congress has rebuffed their

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14 *See, e.g.*, 7 *Collier on Bankruptcy*, ¶ 1121.06[1] (Lawrence P. King ed., 15th ed. 1998); Martin J. Bienenstock, *Symposium—Contemporary Issues in Bankruptcy and Corporate Law; Conflicts Between Management and the Debtor in Possession's Fiduciary Duties*, 61 U. Cin. L. Rev. 543, 560-61 (1992).

efforts. They now ask this Court to re-balance the bankruptcy laws in their favor.

In the instant case, the undersecured Bank holding a non-recourse loan asks for even more leverage than a fully secured creditor would have had in the same case. Fully secured creditors have no unsecured debt and hence no power to vote to block a plan. The provisions for confirmation of a plan over a secured creditor's dissent do not bar old equity owners from receiving or retaining property under the plan on account of their old interests. If undersecured credtiors are given the power to block plans by voting the unsecured portion of their claims, they will have more leverage in bankruptcy proceedings than their fully secured counterparts.

If undersecured creditors have greater leverage than secured creditors, the incentives for marginally secured creditors to under-value property increases. Petitioner asks this Court for a rule in which the ability to control a Chapter 11 rises with the amount of undersecurity a creditor can assert. This undercuts every established commercial law principle—both in bankruptcy and out—to treat fully secured creditors better than all other creditors and to encourage secured creditors to take adequate collateral to cover their loans.[15]

Using the leverage they enjoy through exclusivity and a number of other Code provisions and frequently calling on old equity for infusions of new cash, more than a quarter of the Chapter 11 cases filed from 1989 through

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15 Section 506(c), for example, permits an oversecured creditor to collect interest during the pendency of a bankruptcy while denying interest to the undersecured creditor. In *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assoc. Ltd.*, 484 U.S. 365 (1988), this Court refused to expand the leverage of undersecured creditors to liquidate a business by requiring interim interest payments. The Court stated, "Section 506(b)'s denial of post-petition interest to undersecured creditors merely codified pre-Code bankruptcy law, in which that denial was part of the conscious allocation of reorganization benefits and losses between undersecured and unsecured creditors." *Id.* at 373.

1995 have resulted in confirmed plans. Gordon Bermant and Ed Flynn, *Bankruptcy by the Numbers, Outcomes of Chapter 11 Cases: U.S. Trustee Database Sheds New Light on Old Questions*, Am. Bankr. Inst. J. 8, 32 (February 1998). Although their recoveries are often limited, unsecured creditors recognize that without reorganization, they would have had little chance of collecting anything in many of these cases. Only about 5% of Chapter 7 cases produce any assets for distribution to unsecured creditors. Michael J. Herbert and Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984-87*, 22 U. Rich. L. Rev. 303, 315-16 (1988). Often unsecured creditors support a reorganization even with a small payout because they hope to keep a valuable customer in the future. If this Court increases the leverage of dissenting creditors at the expense of creditors who support a plan of reorganization, liquidations will increase.

The long-term effects of eliminating new value plans would fall squarely on unsecured creditors. The leverage that comes from a debtors' opportunity to propose a plan and offer an infusion of new cash currently stimulates many secured creditors to buy up unsecured claims in the hopes of controlling the reorganization. This directly benefits the unsecured creditors, even at the expense of old equity.[16] If this Court rebuffs the new value principle, unsecured creditors will get nothing unless the debtor has unencumbered assets or is solvent. Similarly, the creditor in the instant case proposes to pay off the trade debt to

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16 Among the many examples of secured creditors buying the claims of unsecured creditors so that they could control the Chapter 11 process are *Figter Limited v. Teachers Insurance and Annuity Association of America (In re Figter Limited)*, 118 F.3d 635, 638-39 (9th Cir.), *cert. denied*, 118 S. Ct. 561 (1997); *255 Park Plaza Associates Limited Partnership v. Connecticut General Life Insurance Company (In re 255 Park Plaza Associates Limited Partnership)*, 100 F.3d 1214 (6th Cir. 1996). The returns to the unsecured creditors in these cases can be substantial.

make its petition more attractive, but if this Court establishes the principle that undersecured credtiors can terminate a reorganization effort and seize all the assets of the business, there will be no need to pay anything to any unsecured creditors in the future.

In the instant case, trade debt was a relatively small part of the business—$160,000 versus a $93 million dollar loan from a secured lender.[17] But if the secured lender can foreclose on all the assets of this business and leave nothing for the trade debt, their loss will be complete. For some tradespeople, including some of the 45 trade creditors involved in this case, the loss of $5,000 may be more difficult to recover from than the loss of millions for a creditor in the business of making loans and sharing loan participation. Congress constructed the Bankruptcy Code to make certain that a single dominant creditor could not control the reorganization process, requiring that voting within a class be based both on dollar amount of debt and number of separate creditors. 11 U.S.C. § 1126(c). The protection for smaller creditors will be written out of the statutory scheme if this Court permits a single large secured creditor to form a separate class to block a reorganization supported by another class of unsecured creditors.

Any ruling from this case will apply in a wide variety of factual settings, including those where the relative position of undersecured and unsecured creditors is reversed. The petitioner urges this court to follow a rule in which trade creditors with $93 million in outstanding debt would lose everything while a secured creditor with a $90,000 deficiency on a loan voted its unsecured debt in a separate class to block any reorganization in which part of the infusion of capital came from old equity. The ruling

[17] This characterization skips over the point that the general partner of the debtor and an affiliate held allowed unsecured claims totaling $7.7 million; the general partner held another claim based upon an $11.3 million second mortgage. App. 103a, 129a.

made by this Court will also affect efforts to reorganize businesses of all sizes, large and small. It will affect creditors with small claims and those with enormous interests, such as claimants in mass tort cases and environmental liability cases. It will also affect the reorganization possibility for nonprofit corporations and owner-managed businesses. When this Court addresses the balance to be struck among the many parties competing for payments from a troubled company, the implications will be felt by every stakeholder—secured creditors, unsecured creditors and equity—as well as every employee, every local taxing authority, every community, every supplier, and every customer of a business in trouble.

CONCLUSION

For the foregoing reasons, the NACM respectfully requests that the Court affirm the decision of the Seventh Circuit.

Respectfully submitted,

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